TESTIMONY OF ROBERT JOYCE
ON BEHALF OF
THE PROPERTY CASUALTY INSURERS ASSOCIATION OF AMERICA
BEFORE THE
SUBCOMMITTEE ON CAPITAL MARKETS, INSURANCE AND GOVERNMENT SPONSORED ENTERPRISES
AND THE
SUBCOMMITTEE ON HOUSING AND COMMUNITY OPPORTUNITY
COMMITTEE ON FINANCIAL SERVICES
UNITED STATES HOUSE OF REPRESENTATIVES

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My name is Robert Joyce and I am Chairman and CEO of Westfield Group. Our insurance group writes personal and commercial insurance in the Midwest and South Atlantic regions of the U.S. We insure homes, autos, farms and businesses writing just over $1.5 billion in premiums in 2006. I am also vice chairman of the Property Casualty Insurers Association of America (PCI). PCI is a trade association representing over 1,000 property/casualty insurers that write almost 40 percent of the homeowners insurance sold in the United States. PCI and Westfield have a significant interest in ways in which we can better prepare our industry and our nation to respond to natural disasters. Thank you, Chairs Kanjorski and Waters and Ranking Members Pryce and Biggert for providing me with the opportunity to appear before you today. Please know that PCI is committed to working with the committee to find ways to reduce the risk of significant loss to homeowners.

Introduction

PCI testified before the Subcommittee on Housing and Community Opportunity in June and September of 2006 and March 2007 concerning natural disaster issues. We are pleased to be invited here today to discuss H.R. 3355. Developing effective public policy for natural catastrophes is one of the most significant issues facing the nation and the insurance industry today. Experts agree that America faces the likelihood of more frequent and severe natural disasters in the coming decade. Moreover, significant property development, population growth, and rising real estate prices in areas prone to natural disasters exacerbate the potential for larger human and economic losses. These facts require stronger loss prevention and mitigation and greater financial resources for recovery.

Peter L. Bertstein, a Wall Street investment manager and consultant, in his book; *Against the Gods*, discusses the importance of measuring risk, from both a financial and survival standpoint. In order to manage risk, one must consider the consequences of risk. This is a fact for insurers as well as businesses and individuals. We must all do a better job of managing our risk. For this reason, when it comes to insuring against the financial devastation caused by natural disasters, all of us share the same goals. We want to reduce the losses from catastrophes by making homes stronger and people safer. We want to limit development in the highest risk areas through effective land use management. And we want to make insurance more affordable and available by combining private market competition with appropriate governmental participation to assure that we have the financial strength to weather any storm.

PCI believes there may be a property structured role for the federal government to play in assisting the financing of mega-catastrophe risk and we believe it should be given serious consideration by Congress now - before the next crisis. We commend you and your colleagues for your attention to and leadership on this issue and for your continued efforts to find innovative solutions to the problem of catastrophe risk such as H.R. 3355. This bill contains a key provision that PCI has been advocating for more than a year; a "liquidity loan" program for State or regional catastrophe funds.

Many other ideas such as federal reinsurance, expansion of the National Flood Insurance Program (NFIP) to include windstorm and flood coverage, flood insurance program reform, a study commission, tax-favored individual and/or insurer accounts to allow for the accumulation of funds to pay for catastrophic events, etc. have been put forth since the 110th Congress has convened. While PCI believes that some of these ideas should be considered and carefully debated further, we believe that the "liquidity loan" program provision in Title II of H.R. 3355 should be one of the key elements of a comprehensive public-private program to address catastrophe issues. The goal of our industry and, we believe, any federal response is to make sure that following a major catastrophe, our policyholders and the citizens of this country can rebuild and get their lives back on track as soon as possible. Accordingly, a public-private partnership that provides financial stability to the industry, the states, and allows insurers to do their job following a major event is essential.

Comments on the Catastrophe Problem

PCI members play a pivotal role in protecting American homeowners and supporting our nation's housing markets by providing the products and services needed to protect homeowners, lenders, businesses, and communities against exposure to natural catastrophes. Our members are proud of the work they do in these markets.

In 2004 and 2005, property insurance markets have been tested as never before. Catastrophe losses in 2005 totaled some $61.9 billion, nearly doubling the previous record losses in 2001. Hurricane Katrina itself caused nearly $40 billion in insured losses, surpassing the roughly $32 billion from 9/11. The vast majority of claims from 2005's events have been paid and the insurance market has met its financial obligations. In PCI's view, the most important catastrophe issue facing us today is whether the market has, or is building, the capacity to pay for catastrophes the nation will face in the future.

Given the very serious catastrophe losses we've seen over the past several years and the significance of this issue for our membership, our organization has devoted considerable time and effort to develop sound public policy solutions that we can recommend.

There are several fundamental issues that have to be addressed:

- First, America clearly faces the prospect of increased frequency and severity of major hurricanes and the continuing threat of other major natural catastrophes including earthquakes, floods, tsunamis, and volcanic eruptions. Weather modelers tell us that we are in a prolonged period of increased severe storm activity. Seven of the ten most costly natural disasters in U.S. history have occurred since 2004. We can't afford to ignore this reality.

- Second, America is experiencing significant development, population growth, and rapidly rising real estate prices in areas that are highly prone to natural disasters. AIR Worldwide, one of the leading risk modelers in this country, states that there is currently some $7 trillion in property values exposed to catastrophe risk along America's coastlines; some $3 trillion of it is personal property. Even if storms were no more frequent or severe than in the past, this fact alone means that future storms will be more damaging and more costly to insure. As a result of migration and property development, the nation faces growing exposure to significant catastrophe losses and increasing costs of recovery. "Baby-boomers" have moved to warmer climates and coastal areas so that now, more than 54 percent of the U.S. population lives within 50 miles of a coast.

- A growing number of Americans have a significant portion of their net worth exposed to catastrophic loss. The impact of major natural catastrophes on the economy will be larger and will likely lead to significant public policy debates over how best to address this risk.

- As an insurer, Westfield Insurance and other PCI members would prefer to rely on free global market forces to solve this problem whenever possible, with prices and products tailored to match the risks freely assumed. We think that such an approach would, over time, establish appropriate economic incentives for those who live and work in catastrophe-prone areas and would attract badly-needed private capital for risk protection. However, we must also recognize that our industry does not operate in an unregulated market. Our members work in a world where prices and coverage terms are highly regulated and generally are not allowed to respond freely and in an immediate fashion to changing risks or conditions.

  We also recognize, as we must, that people do not simply pick up and move from one place to the next, irrespective of their homes, families, and community ties. Any set of realistic policy options must take this into account.

- Finally, with respect to preventing and reducing losses, states frequently have outdated and inconsistent requirements for building codes, code enforcement, and other prevention/mitigation tools in areas dangerously exposed to disasters. These weaknesses imperil lives, property, and policyholder resources.

We agree with Congress that this is a major public policy issue that must be addressed; we believe the problems posed by catastrophe risk are growing more severe; and that a range of potential solutions must be considered, including market reforms, stronger loss prevention, and new approaches to financing catastrophe risk. We do not believe there is one "silver bullet" to solve this problem, but rather a full range of changes that will have to be made.

Policy Options to Consider

As we look at the issue, PCI suggests four major areas for consideration.

Reduce Exposure to Catastrophe Losses

First, we need to do more to control and reduce catastrophe exposure. PCI suggests the following:

- We believe state and local governments must take seriously the need to restrict development in catastrophe-prone areas. This is not only an issue for single family homes. Ongoing commercial development on our nation's barrier islands or in the wetland marsh areas also significantly increases these risks.

- State and local governments should urgently and immediately review their building codes in catastrophe-prone areas. Wherever needed, they should upgrade their codes. Stronger building codes protect lives and significantly reduce property damage and repair costs. In a highly competitive insurance market, those savings will be passed directly back to consumers. Some have argued that it costs too much to rebuild to meet modern building code standards. Louisiana State University's Hurricane Center has estimated that the marginal cost of building a structure to meet higher wind-borne debris requirements in the International Residential Code is between 1.5 and 4.5 percent of additional cost. On a single-family home with a $100,000 mortgage, that works out to about $27 extra dollars per month. We think such investments are vital.

  PCI supported passage of minimum building code legislation in Louisiana and Mississippi in 2006, as well as an unsuccessful effort to extend stronger building codes into the Florida panhandle. However, the Florida legislature realized that this delay in applying its strong statewide building code in the panhandle was inappropriate and in its 2007 special legislative session on insurance, eliminated this exception. Finally, as much as we supported and are proud of our work to enact stronger codes in Louisiana and Mississippi, we know that much work needs to be done to implement and enforce these new standards, including making sure there is enough funding for the training of building inspectors.

- A second idea is the establishment by the federal government of incentives for greater investment in loss reduction and prevention. We suggest consideration of several ideas. First, the insurance industry's Building Code Coalition has recommended that enhanced disaster mitigation grants under the Stafford Act be provided for states that adopt stronger statewide building codes. This would address the funding issue mentioned above and PCI strongly endorses this approach and urge Congress to enact legislation for this purpose. Roughly one dollar spent to better protect a property results in four dollars saved following an event. Clearly, one of the major limitations of any new building code enactment is the fact that it typically can't address improvements needed in the existing housing stock. This approach gives homeowners themselves additional incentives to make these improvements.

- We believe greater steps can be taken for preparedness and PCI has completed and distributed to forty-eight state insurance departments a PCI Regulators' Kit, containing recommendations for disaster preparation and response. This kit contains model regulations covering five critical areas, including: establishing an Insurance Emergency Operations Center; disaster claim reporting requirements; cancellation and non-renewal of insurance under disaster conditions; suspension of premium payments under disaster conditions; and mediation of disputed claims. When adopted, these regulations could improve the necessary coordination and communication after a catastrophe and help those whose lives and property are at stake.

Fix the Flood Program

Second, we believe Congress should complete its efforts to reform the NFIP. PCI strongly endorsed reform efforts last year and we continue to do so. The NFIP is a necessary policy response and must be continued. However, the program needs numerous reforms, the majority of which are contained in the Flood Insurance Reform Act of 2007 as introduced (H.R. 1620); but not as passed by the House Financial Services Committee in late July (H.R. 3121). The inclusion in H.R. 3121 of provisions that would expand the NFIP to include providing coverage for windstorm and flood losses is not something that PCI supports. We continue to believe that making a major change such as this to a program that is in need of other significant reforms in order to address current issues is unwarranted. We support efforts to pass a flood insurance reform bill this year, without the "multiple-peril" provision and we are willing to work with you to accomplish this goal.

Expand Private Sector Capacity

Third, a key part of the long-term solution to natural catastrophe exposure is to expand private sector capacity to handle the risk. PCI strongly supports efforts to make markets more responsive to the risks we face. Prices and terms of coverage that are openly and freely established in competitive markets can create essential incentives for property owners and attract new capital to these markets. As you know, homeowners insurance markets are heavily regulated in virtually all aspects of their operations. We face significant regulatory constraints, particularly in rating, but also in other areas, that inhibit effective market responses and discourage capital from entering these markets. We believe that the markets will need to transition to address availability issues. There are several things we think policymakers at various levels of government can do to address this problem:

- Insurance markets need greater freedom to respond to the exposures we face. In free markets, prices and terms of coverage tell consumers the true cost of insuring against catastrophes and are an efficient means of funding exposures. Regulators often fear that giving up regulatory control will make the problem worse and invite consumer backlash. However, based on the experience we've seen in states that have taken this approach, including South Carolina and New Jersey most recently, we believe the results would be just the opposite. Free markets encourage new capital to enter where insurance protection is needed and develop more capacity, not less. PCI will support state legislative initiatives intended to remove regulatory barriers to free markets for catastrophe insurance and will oppose enactment of new barriers.

We also encourage your review of two additional proposals:

- We are very interested in, and in fact endorse, establishing voluntary, tax-deferred insurance company catastrophe reserves such as H.R. 164 introduced by Rep. Jindal. H.R. 164 contains provisions that PCI believes should be modified, and as such, we have provided some members of these committees with draft wording and, in fact, have drafted legislation that we believe addresses these issues and would be happy to work with the author to modify H.R. 164 or with any member of these committees to have our version of this legislation introduced, debated and, hopefully, passed by Congress.

- We believe that there may be specific steps that could be taken to remove regulatory, legal, accounting, or tax barriers to further growth in the catastrophe bond market. This market provides another outlet for catastrophe risk financing and introduces new sources of capital and competition. A report earlier this year from Guy Carpenter described the growing importance of this market for financing catastrophe risk. While we certainly don't see the cat bond market displacing traditional reinsurance, market participants tell us that bringing more of these offerings "onshore" and reducing a variety of regulatory barriers will permit the market to grow. In principle, PCI strongly supports steps that will attract more private capital to address catastrophe risk and we are very interested in how this might be done in the catastrophe bond market.

Title I of H.R. 3355 establishes a federal "consortium" that addresses the goal of bringing new capital into the marketplace. As drafted, this consortium would be a "centralized repository" for all the information related to catastrophe risks and would have the ability to "issue securities and other financial instruments" and enter into "reinsurance contracts with private parties". We understand from speaking with the bill sponsors' staff that the Consortium envisioned will in no way provide a tax advantage and should explicitly not compete with or crowd out the private marketplace. PCI hopes that the Committee will clarify the bill language during markup of H.R. 3355 on this point and is encouraged to see such a forward-thinking idea included in the legislation. We look forward to working with you to modify these provisions so that capital market solutions such as catastrophe bonds can be more easily established and be less expensive.

State and Federal Government Involvement

Finally, with regard to state and federal government involvement:

- Based on our review of this issue, we believe the growth in natural catastrophe exposures is of sufficient magnitude in some states that it may require consideration of state natural catastrophe funding facilities. The events of 2004 and 2005 show that the insurance industry can respond to very severe catastrophe events. However, private markets may not always have the capacity to fund increasingly more frequent exposure to "mega catastrophes" or to a series of very large events in a single season. Given the magnitude of risk in certain states, our approach will be to look at specific conditions in each state to determine whether a catastrophe fund, or other financing mechanism, might be helpful.

  When we consider whether a state needs a catastrophe fund, we look also to see: (1) whether private markets have pricing and underwriting freedom to respond to market conditions; (2) whether care has been taken to prevent a catastrophe fund from damaging stable private markets or preventing new capital from entering the market; and (3) that the funding of the state program doesn't rely on cross-subsidies across lines of business. By their nature, cross-subsidies damage the ability of markets to provide strong price signals and incentives for behavior. Having said that, we believe there may be cases and states where a catastrophe fund can be part of a well-rounded solution and must be considered.

- Second, we would suggest that there may be some mega-catastrophe exposures that are beyond the capacity of the private market and even of an individual state catastrophe fund. In these times, following "mega catastrophes", it may be necessary for the federal government to offer liquidity protection to state catastrophe funds to stabilize markets and avoid widespread insurer insolvencies. Federal involvement may also be essential if the nation suffers repeated large events within a short time period. Lest anyone thinks that scenario is impossible, we would remind you of how close Hurricane Rita came to hitting Houston last year, only a few weeks after Katrina devastated New Orleans and the Mississippi coast. It is not inconceivable that several of our major cities could be struck by Category 4 or 5 storms within a single season, or that a major earthquake could strike in the same year as a significant hurricane.

H.R. 3355, Title II, Section 202 contains provisions for "liquidity loans". We are pleased to see the "liquidity loan" idea incorporated into H.R. 3355. Such a facility would offer credit financing to state catastrophe funds, intended to provide access to cash to meet immediate claim requirements following a qualifying event or events. However, we are mindful of the need to be extremely careful in structuring any federal role and of the overriding need to attract new private capital to the market. Accordingly, any federal financing role should include measures intended to promote freedom for markets to respond to these exposures, including support for greater rating freedom, support for actuarial soundness of private market rates, freedom for product innovations, use of sound underwriting tools, and lower market barriers. While the "liquidity loans" are provided for a "qualified reinsurance program" in Section 202 of the bill, there do not appear to be any requirements that would promote market freedoms, as the term is defined in Title III, Section 301. The point of connecting standards for market freedoms to the creation of a federal financing facility is to provide incentives for the states themselves to do everything they can to attract private capital before asking for federal assistance.

Title II of H.R. 3355 includes a provision that allows for these liquidity loans to be made once the insured losses are "in excess of 150 percent" of the area's "aggregate direct written premium for homeowners insurance" for the previous calendar year preceding the event. PCI believes that the threshold for liquidity loans is too low and would negatively impact the private market. A task force of PCI members thoroughly analyzed the trigger level issue and we would like to share some the results of their work with you.
PCI believes that it is extremely important to develop trigger levels based on actual historical events evaluated in today's dollars. The PCI Task Force began with the belief that the threshold to qualify for federal liquidity financing should be a one-in-75-year event. This is an event that has a one-percent chance of occurring every 75 years. We felt that this was a justifiable benchmark because it is approximately $80B of insured loss, which is also approximately the sum of insured losses of the 2004 + 2005 storm seasons. It is a repeat of the 1926 Category 4 storm that hit Miami, adjusted to 2006 costs. We also measured this threshold using a major earthquake in California which would result in approximately $89B of insured loss, essentially a repeat of the 1906 San Francisco earthquake.

We took into account the fact that in many cases hurricane damage seems limited to only one state. We recognized this and understood that something was needed for the single state event that would be devastating to that particular state, yet may not reach the one-in-75-year benchmark. As such, we determined that an alternative benchmark of five percent of a state's gross product would be a fair and easily quantifiable threshold to qualify for financing from the federal liquidity facility, especially for smaller states.

Using the five percent trigger, the Florida Hurricane Catastrophe Fund might qualify fairly readily in a bad – but not extreme – year. Five percent of that state's gross product in 2005 dollars is $34B. It should be noted that, in 2005 dollars, Hurricane Camille caused a loss equal to 14 percent of Mississippi's gross product and that Hurricane Hugo caused loss equal to seven percent of South Carolina's gross product. Under H.R. 3355's provisions, Florida would be able to access the "liquidity loans" following an event that caused insured losses of just over $10 billion. The state and private markets in Florida have the ability to respond to such events.

Section 202 provides for "catastrophic loans" to state or regional catastrophe funds, under certain circumstances that are not "qualified reinsurance" plans or to "state residual market" entities. PCI understands that this would provide a mechanism for states without existing "qualified reinsurance" programs to access federal funds to pay claims using the same threshold for losses as with the "liquidity loan" program. PCI believes that making these "catastrophic loans" available to these entities would impede private markets and would send the wrong signals to states that have created programs to cover losses from catastrophe risks. These types of loans appear to allow states to benefit from a federal loan program without taking the necessary steps to do everything possible to allow market freedoms, reduce or prevent losses and allow risk-based premiums before seeking federal assistance. Also, for the reasons stated above, we believe that these thresholds are too low. The provisions of this legislation also do not specify where funds to pay back these “catastrophic loans” would come from, leaving it up to the states and the entities borrowing these funds to make that determination. PCI is concerned that the costs of these loans could simply be passed on to insurers without the ability of insurers to recoup these costs from policyholders through specific premium adjustments or surcharges. Following such actions, policyholders in these states could be faced with insurer insolvencies, further adding to the problems following a catastrophic event. Therefore, PCI recommends that the “catastrophic loan” provisions be redesigned or substantially modified.

Conclusion

On behalf of PCI and its members, thank you for the opportunity to appear here today. PCI and its members look forward to working with you on H.R. 3355 to address these very important issues.